DOW THEORY LETTERS INC.

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September 17, 1975 Letter 642

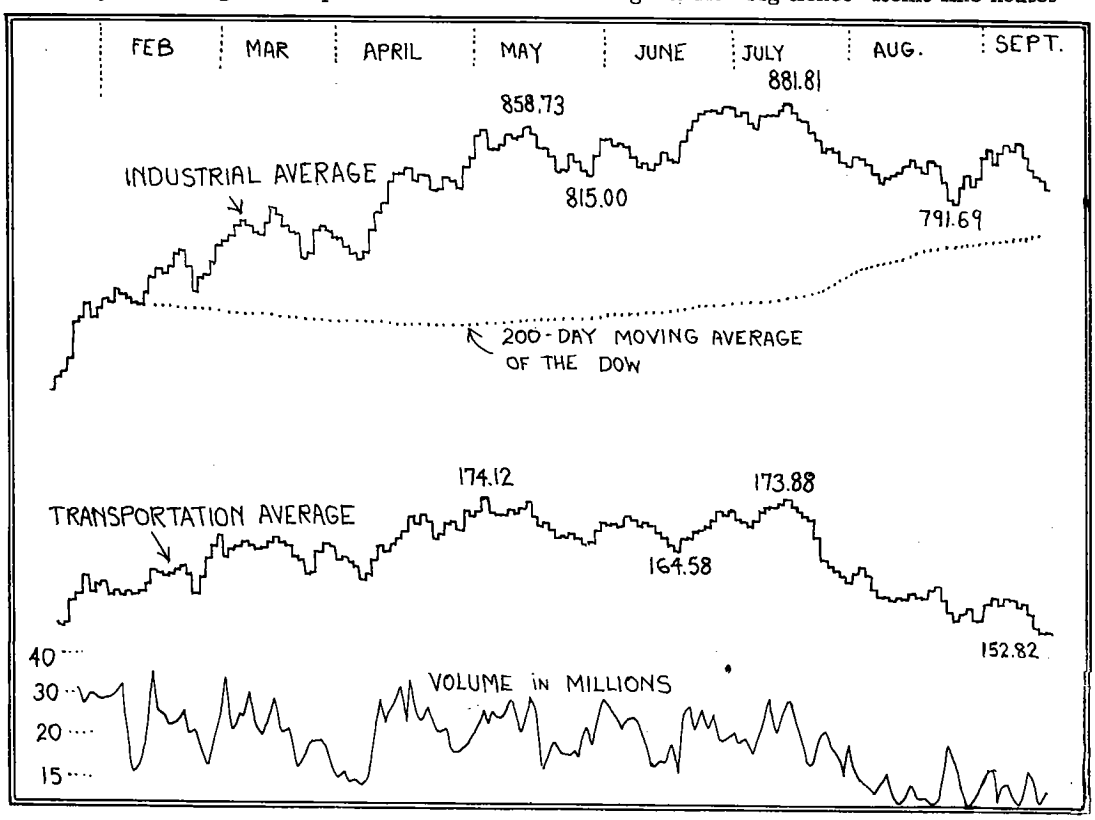
THE BIG SQUEEZE appears to be on. There isn't enough money around to service all the debt. New York State was forced (last week) to pay up to 8.7% for notes backed by "full faith and credit." Retail sales in the US fell in August, the first drop in five months. The prime rate went to 8% on September 12. In the face of a tottering financial structure, incredibly, NYC's teachers went out on strike! Who's getting hurt by the big cash squeeze? The answer is everybody and everything, from stocks to bonds to gold to retail sales.

What's the answer? There are three ways to get rid of too much debt. The honest way, which is cut back expenses and pay the debt off. So far, nobody's interested in that one. The second is to let the debt structure collapse. We're getting close to that, and in many places it's actually happening. The third way is to move into hyper-inflation so that the size of the debt (in constant units) is diminished to the point where it ceases to be a problem. The Administration hasn't really chosen that one yet (at least they don't openly admit it), but it could be about to happen.

As we move closer to the moment of truth for New York City, we start hearing new sounds. Mr. Burns of the Fed has stated that, if necessary, the Fed will make low cost loans to member and non-member banks. Mr. Burns doesn't want that potential panic feeling to get out of hand. So we come into the "Age of the Guarantee," the age when everyone is strapped for cash, and in order to do business each higher-up guarantees the one below him. The boss will guarantee the worker, the city will guarantee the boss and his business, the state will guarantee the city and the Fed will guarantee the state.

"But who will guarantee the Government?" That's the question we're all silently asking. For after all, who runs the Government but a bunch of blasted fools, just like you and me! Well, the answer is that the Government has an advantage, because they can increase taxes, they can remove tax shelters, they can dream up new taxes, and they can force the Fed to at least try to pump up the money supply.

In Letter 640 I noted that money isn't turning over the way it should be (checking account velocity). My feeling is that the nation is up against the wall, and the consumer just hasn't got it to spend. Consumers are cutting out the "big ticket" items like houses and cars, and maybe going to McDonald's a little more often because a Big Mac and some fries makes you feel like a spender, even if you are still driving the same VW that you drove four years ago.



Probably the biggest shocker of all is the way Washington keeps upping the amounts of money they need. Almost weekly we get a new revision on cash needs from the Treasury. And the bond market sinks a few notches lower, interest rates rise, and stocks are squeezed further in the great interest-rate vice that is becoming the trademark of the 1970's (Wall Street's version of "Jaws").

The choices from here on are difficult indeed. If the Government follows the super-inflation route, well, people may not

react in the "expected" way. People are hip today; they are genuinely afraid of inflation. Ten years ago Mr. America would have rushed into the stock market at the first sign of renewed inflation. Now he grits his teeth and goes out on strike for more money.

On the other hand, if the Government levels with the citizens, tells them that Washington is choking because it is running out of ways to raise money, running out of ways to guarantee, running out of propaganda about the "coming business expansion," that would probably set off some kind of panic (perhaps for no other reason than that people aren't used to hearing the truth).

A year ago people were astonished because they just didn't believe stocks could go so low. "Good companies selling at 50% to 85% below their bull market peaks!" It didn't seem possible. "Why," they asked, "Why is it happening?" None of us could figure out what catastrophe the market was discounting when it crashed during 1974. Maybe the market was seeing then what we're just beginning to see now, a situation in which there are no answers—just choices. And what choices they are: hyper-inflation and then depression or just plain sinking into a recession-depression while the Government keeps mumbling about guarantees.

The September 22 latest issue of Business Week has on its cover the story, "Capital Crisis, the $4.5 Trillion America Needs to Grow." And I look at the bids drying up in the bond market and wonder, what are these guys thinking about? If America needs $4.5 trillion to grow, then brother, we're going to stop growing, because the money ain't there. And there's the great, startling secret fact—we're going into the period of the "new way of life," and that new way is symbolized by the mini-car, the motorcycle, wine instead of whisky, and soy-filled sausages instead of the real piggly-wigglies.

Any way you look at it, 1976 is shaping up as a real lulu. Will we see "blood on the streets" as my friend, James Dines, predicts? I don't know for sure, but I'm not throwing my mop away quite yet. Meanwhile, let's turn to the market. Wall Street has access to more knowledge than Washington will ever have, but there's always that problem—who can read the Averages correctly?

THE MARKET: The pattern of the Averages is well worth studying at this juncture. Starting from their August 21 low of 791.69, Industrials rallied to a recent October 8 peak of 840.11. This represented a rather unspectacular rise for Industrials, a rise which recouped 53.7% of the losses since the 881.81 peak of July 14. All this is easy to follow on the page 1 chart of the Averages.

The Transports were notably laggard on the recovery. From the 152.82 low of August 28, Transports rallied for only three days (!), and in so doing they tacked on 4.42 points. This amounted to a 20.9% recovery of the losses sustained by the Transports since their 173.88 peak of July 15. Thus, the carriers have shown less than half the recovery power evidenced by Industrials.

Not only did the Transports behave in a sluggish manner, but they have failed to confirm the Industrials rise to 840.11. Therefore, as you study the pattern of the Averages, and particularly the pattern since the August lows, I doubt that you will find anything to become rampantly bullish about.

Nevertheless, where the market is concerned, it never pays to leap at the obvious. Jumping to obvious (and often erroneous) conclusions can be just as dangerous on Wall Street as waiting and procrastinating when we should be moving. Note that the recent low for Industrials was 791.69 (August 21) while the comparable Transport low was 152.82 (August 27). On September 10 the market plunged and Transports broke to a new low of 152.29. Industrials refused by a wide margin to confirm.

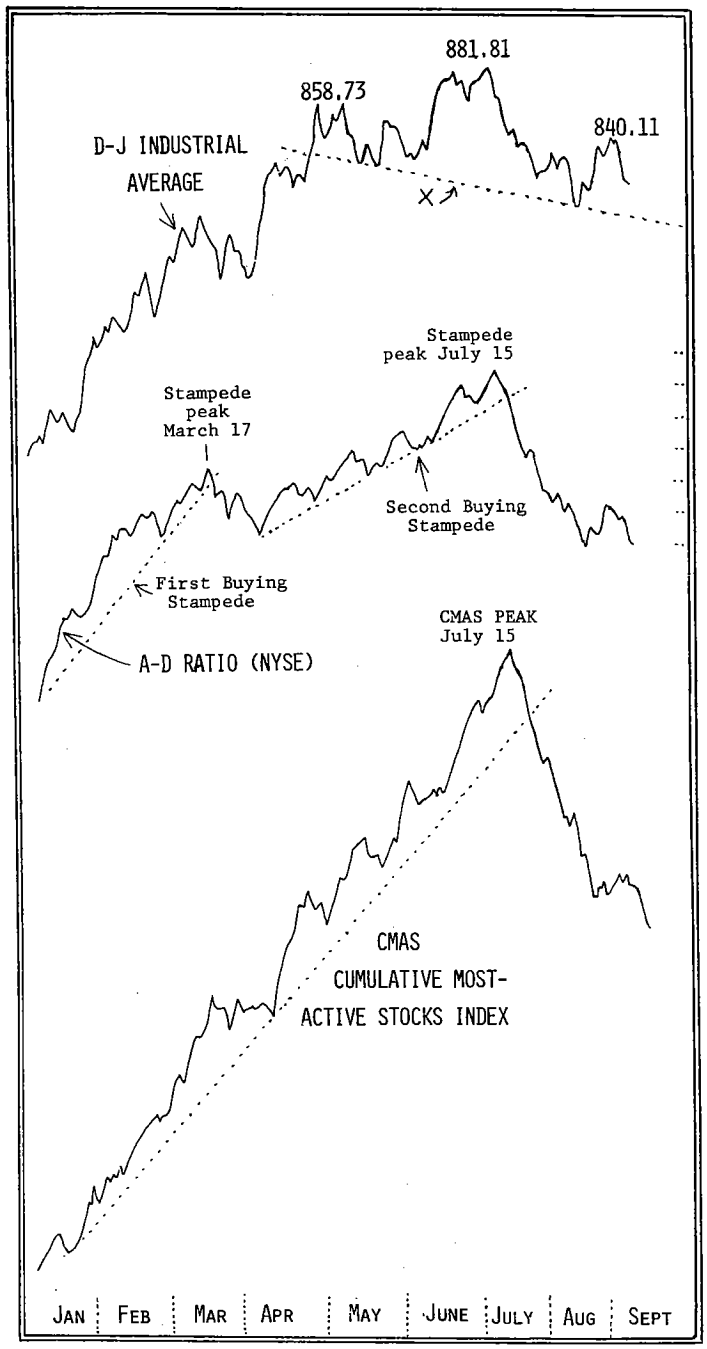
Thus we now have a new critical level, 791.69 for Industrials. A plunge by the senior Average through that point (particularly on rising volume) would indicate a new major downward leg for this reaction. Conversely, a stubborn refusal by Industrials to penetrate the 791.69 level would suggest an extension in the rally which began in late August.

What's my guess? I would guess that following a period of rally, backing and filling and bouncing, we will get a second downward leg on this correction. Such a descending leg should take us well into the October-December time period.

While I'm at it, I want to say again that I believe the Transportation Average has been sending us the correct message ever since its May 5 peak of 174.12. By refusing to move higher, the Transports have been saying that the supposed "big business boom" is going to be held in abeyance this fall and probably this winter? The trucks, rail cars and air freight terminals are going to have space to spare, according to my interpretation of the Transport Average's action, and that lack of activity has to rub off on the Industrial sector. After all, if you run your manufacturing plant at full blast, but your salesmen are not selling the autos and shoes and tooth picks, then the boys in the factories are in for a slowdown. And that's the confirmation principle, brought down to a simple dollars and cents basis.

As an interesting and perhaps tell-tale aside, it should be noted that the Transportation Average was 143.44 on December 31, 1974. So far in 1975, we find the Transports less than 10 points above that level (around 6% above the December 31 close). The "five years" are the strongest years of the decennial pattern, and going back through history we see the following: In 1905 Transports gained 13.5%, 1915 saw a Transport gain of 11%, 1925 a 14.8% gain, 1935 an 11.1% gain, 1945 a 29.8% gain, 1955 an 11.9% gain, and 1965 a 20.5% gain. So far, this is the smallest fifth year gain in history. Let's see how Transports end up the year (no fifth year has ever produced a gain below 11% in Transports — statistics, thanks to Peter Wyckoff).

OTHER INDICES: Turning to the chart on page 3, note that two of the key indicators which we follow have been singularly unable to keep up with the Dow on the August-September rally. The advance-decline ratio pushed up a mere 1.44 points (against 48.42 points in the Dow), and as of this writing the A-D ratio is still within a fraction of its low for the entire move since the July peak.



Just as significant, my cumulative line (CMAS) of the daily most-active stocks (the daily pluralities) did almost nothing on the 48 point Dow rally (see chart). This was an action which can only be termed as extraordinary, considering the great strength in this index during the rise from December, 1974 to July, 1975. On September 10 the CMAS sank to a new low for the move. This break took the CMAS to its lowest level since April 21. From this, I infer that big money, the kind of money that accounts for the important action in individual stocks on the NYSE, is still on the exit trail. It's a phenomenon which began on July 15 of this year. As long as it continues (i.e., as long as CMAS heads down), we can expect ultimate trouble ahead.

Finally, I want to comment again (see the same chart) on the potential "head-and-shoulders" top which appears to be shaping up in the Dow. I have redrawn the support line (marked X on the chart) in view of the August 21 Dow low of 791.69. I would say (to be conservative) that any Dow break below 785 would complete the pattern, and such action would allow for sharply lower prices, prices which could easily take the Dow down to the low 700's or even the 600's. In preceding reports, I indicated that a plunge below 700 would not shock me, and I still hold to that stance.

So I am cautious on the intermediate term, but still bullish on the primary (the long) term. Which means that as far as I am concerned, this isn't the greatest time to be squirrelling away stock certificates. Give the market time to make up its mind, give it time to spell out its story. Those who want to know what the market is going to do tomorrow and those who insist on "action every day" would be well advised to hit the local card room instead (do they have card rooms in the East?). There the conversation is friendlier than in the board rooms, the commissions are lower, the action is faster and the odds are more favorable.

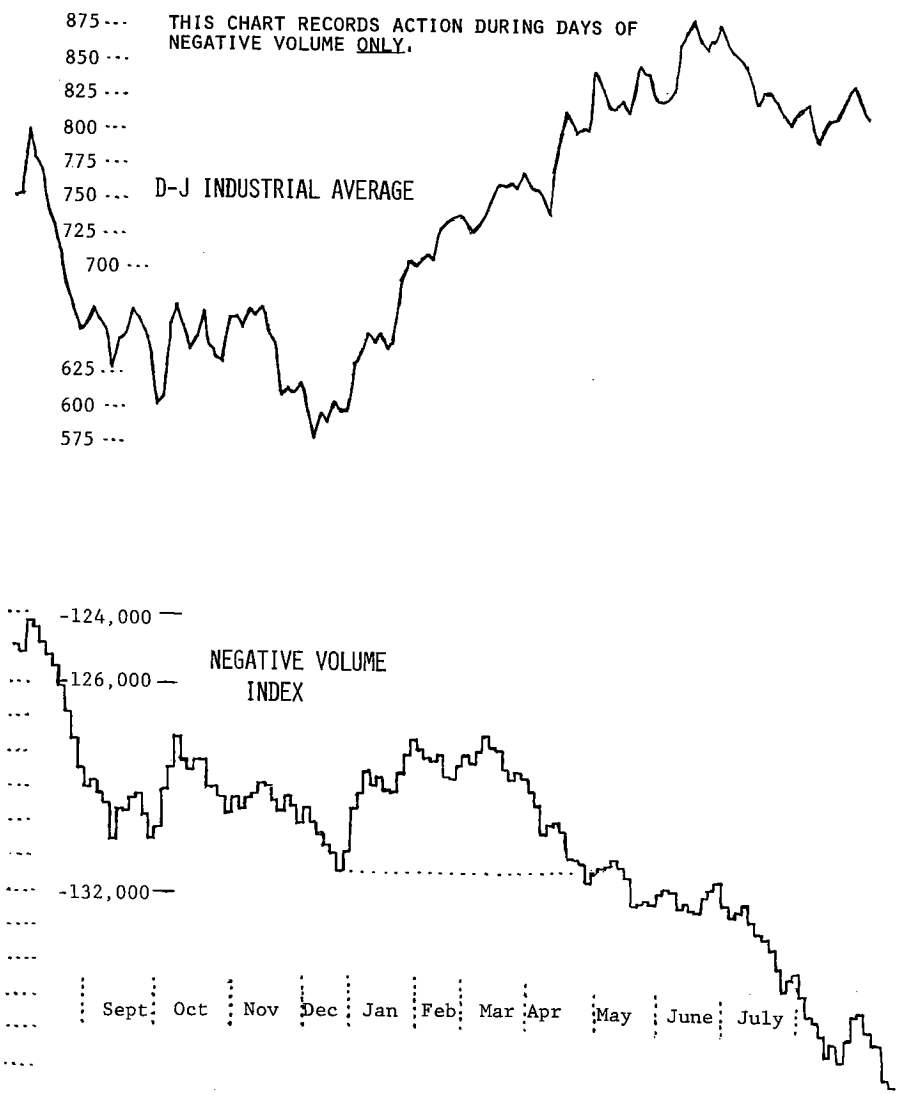
But on Wall Street the word is patience, patience and more patience. Like the tide of the ocean, the market moves to its own beat. You don't change or dictate to the tide, you go along in harmony with it — or get destroyed.

VOLUME: Volume (and the implications of volume) is always a very tricky and difficult study. All the way down from the July highs we were told that "volume is impressively low." That was supposed to provide comfort to the stockholders. If it provided any comfort, it also provided losses. Low volume is only impressive if prices hold on that low volume, but they didn't hold worth a tinker's dam on this decline (more on low volume in the section on negative volume).

Many of the stocks we had purchased back in December-January are now near their old lows, particularly the lesser quality issues. But the majority of my subscribers took their profits months ago (as I suggested they do). Therefore, the grim situation is only an academic one as far as we are concerned. How about the old adage, "Hold your stocks as long as the primary trend remains bullish?" That adage is a good one for most bull markets. But as I've been saying all along, this bull market is accompanied by tight money and a huge debt structure. All of which bothered me and forced me to play it cautiously. Yet it didn't stop us from garnering profits on the explosive rise from the late 1974 lows. And really, why do we mess with Wall Street at all — except in the hope of coming away with more greenbacks than we started with!

NEGATIVE VOLUME: In Letter 368 I introduced the study of negative volume (see page 4 chart). The theory (first introduced by Paul Dysart) is that informed money prefers transacting in the stock market during "quiet days" whereas the uninformed public

tends to buy and sell during "exciting days." Negative volume is registered on any day in which Exchange volume is below the preceding day. Thus, it is conceivable that a whole week can pass without a single NV day, while another week may produce contracting volume four days in a row thereby providing four days of NV. At any rate, the NV index is based on the plurality of the advances over declines (or declines over advances) on any day in which Exchange volume is lower than the preceding day.



Thus the negative volume index is actually a very specialized A-D index based on entries made only on days in which Exchange volume has dropped below volume for the preceding day. The index may also be considered a barometer of informed money, and the direction of the NV index should show the direction in which informed money is moving.

If NV is to be understood, readers should get the following thoughts firmly fixed in mind. One of the most important studies in the market has to do with stock action after a high volume advance. It is very bullish (following such an advance) if stocks tend to hold their gains as volume contracts. Conversely, if, following a good, high-volume advance, stocks tumble on contracting volume it is a bearish manifestation. It means that those who bought the advance are being "hung high and dry" on the ensuing decline. And the declining volume means that they are being locked into an illiquid market with little chance of getting out (it's always easier to sell a stock in a high-volume market where there are plenty of bids).

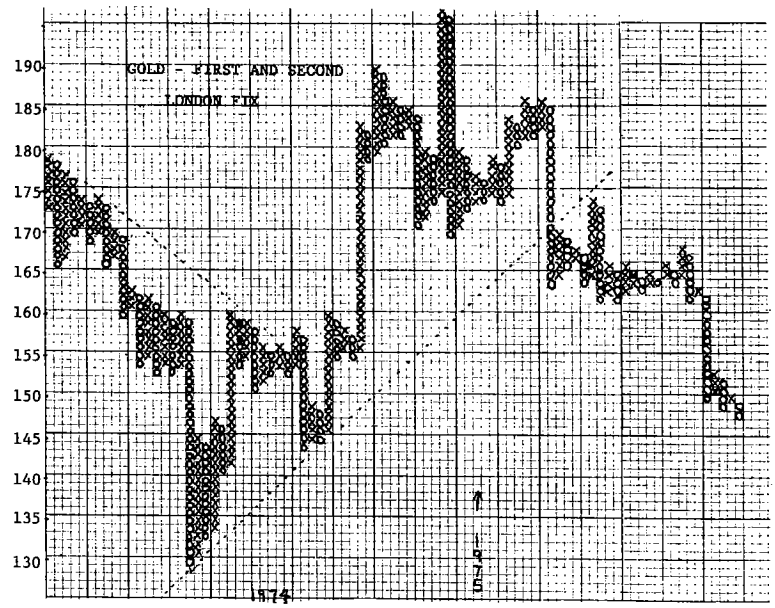
As seen on the chart, the NV hit a high in mid-March, and this is the area that I consider the peak of general strength for this bull market (so far). Following the mid-March peak, NV turned sharply down, and by late-April the index produced an astonishing penetration of the entire structure which had been built up since September, 1974. This type of downward penetration would constitute a "bear signal" on Paul Dysart's original method of interpreting NV.

Since May, NV has turned in an increasingly poor performance, with low after low being recorded. On September 10, a dramatic day appeared in which 877 more issues declined than advanced — all on declining volume. The September 10 break took the NV index to its lowest point of the year. It is clear to me, looking at the pattern of NV on the chart, that the correction of the 1974-75 advance has been very severe. It is also clear that there are many bearish overtones to the correction, overtones that I would rather not see. I said in Letter 368 that the technical structure of the market has been so damaged that it would appear that Wall Street is dealing with a number of unexpectedly ominous factors. Money, I felt, was one of those factors. I am still of that opinion.

GOLD, INTEREST RATES, THOUGHTS: The great argument goes on regarding what the IMF conference meant about gold. No two analysts seem to agree. One thing we do know is that individual nations may now buy gold (as long as the total IMF gold stock is not increased). But will they buy gold? That's what no one really knows, because to buy gold today is a very expensive undertaking, expensive because it means that you forego 10% or more in interest currently available on bonds (8.5% if you want to play it safe with T-notes).

"But everybody's going to inflate," we're told, "the volume of paper money is going up and up (all against a fairly fixed amount of gold)." And that's true, but then we come to the matter of timing. Remember, the market always does what it's supposed to—but never when. It's that blasted "when" that breaks people, or as William Hamilton put it, "Wall Street's graveyards are filled with men who were right too soon."

My point and figure chart of gold doesn't look particularly promising for the near term (and please don't blame me for the way it looks, I only enter the figures each day). Gold fell off the shelf when it broke a quadruple bottom at 161 (I warned repeatedly about that level). Bullion plunged to 150, formed a little "congestion pattern," and it now seems to have broken down again. A normal expectation, following a 10 point drop and then a congestion pattern, is another drop equal to the one that preceded the congestion. If that occurs, gold could come down to 138-140 before too long.



Obviously, all this pressure on the end product (gold) is putting pressure on the already squeezed costs at the gold mines. And the stocks are acting accordingly as they head down to prices that have not been seen, in some cases, since 1973.

According to the latest Economist, international trade in 1975 is running about 10% below the 1974 levels. That's ominous, particularly in a world where huge debt is the order of the day. Now any businessman knows that he can carry a lot of debt as long as everything is turning over rapidly. As long as that's happening, the profits roll in, and the debt can be serviced (even with high interest rates). But let business (or world business) slow down, and the debt will eat you alive (again, the "Jaws" symbol). And that's exactly what is happening to business and nations the world over, today.

Ultimately, we're going to have a collapse — that is, unless the US and leading nations begin stepping on the accelerator. And somewhere ahead we're probably going to see gold move up as it discounts the big, new ocean of money that is fated to materialize. Some of my friends feel that "it's already too late," that confidence is too shattered, that no amount of planned inflation can get the world out of the current mess. Honestly, I just don't know. Intuitively, I feel that if the US moved into the massive inflationary effort that would be required to get a boom going again, we would face a consumer revolt or a march on Washington or a strike of the middle class.

One scary thought is this: If gold is a classic baromater of the value of money, then the recent gold action would suggest that deflation is on the way, that the wherewithall to inflate is about exhausted. A declining price for gold is a deflationary depression, but I do not believe it would survive (as we know it) during a period of hyper-inflation. From that standpoint, be contented that gold is going down, not through the roof.

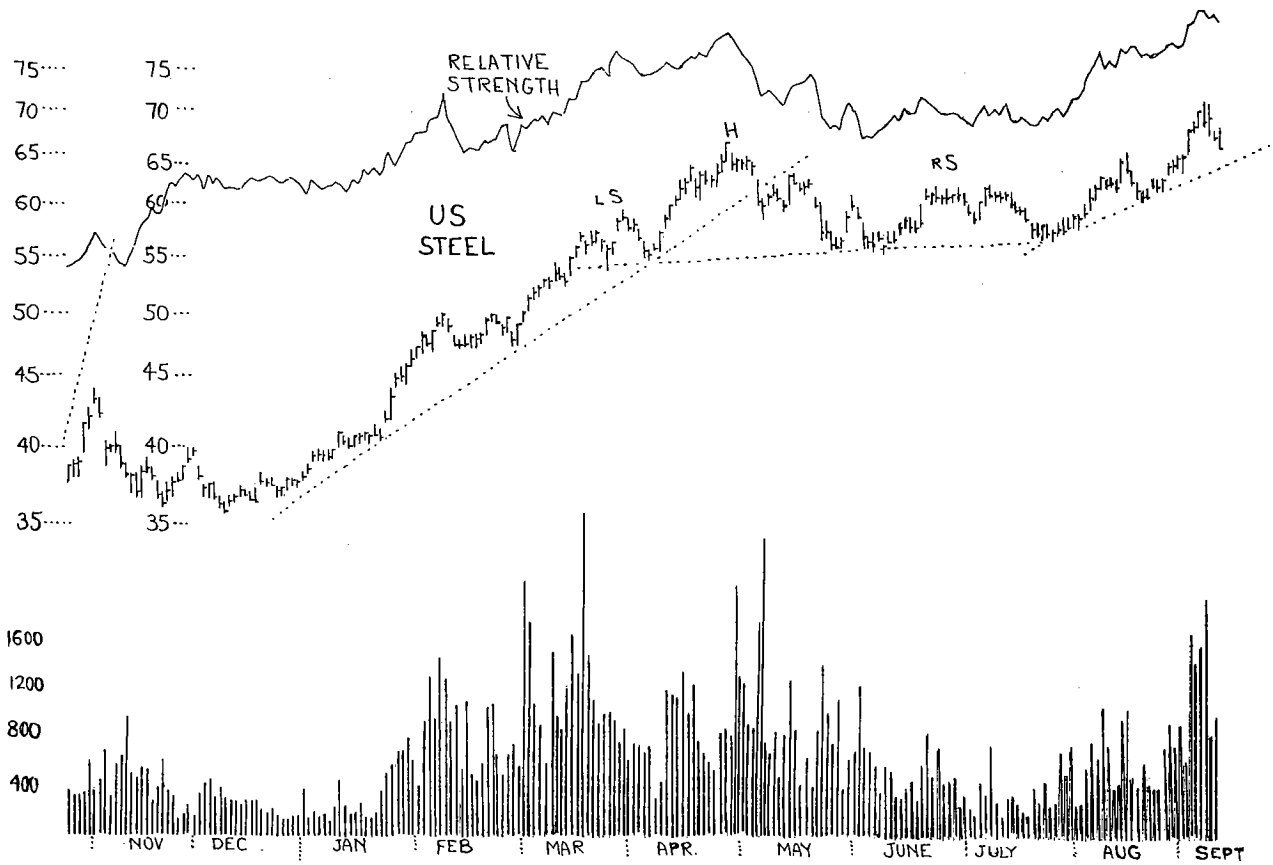
I know that many subscribers are wondering what others say about gold, and since few readers have access to the vast quantities of services and letters which arrive here, this might be a good time to cover a few other sources. The Bank Credit Analyst believes that dollar strength will not last, that there will continue to be a strong inflationary bias, and that "consequently, the underlying attractiveness of gold for both central banks and those in the private sector is unlikely to diminish." The Holt Investment Advisory is of the opinion that because of central bank buying there will be no net increase in the free-market gold supply. Holt foresees a few years of "agonizing depression" followed by a new official gold price that will "probably be in the neighborhood of $200 an ounce" (my comment, is $200 gold supposed to be bullish for gold stocks?).

In a personal letter to me, John McFalls of the gold-oriented Value-Action Advisory has turned bearish on the technical situation for gold. John feels, however, that a more "optimistic assessment of the Labor Day Gold Agreement should give comfort to gold share owners." John adds, however, that "should the (gold) rally exhaust itself before cutting through the overhead supply of stocks being offered, the trap door could be opened and the golds plunge once the optimists have exhausted their buying power."

John continues, "A look at the head-and-shoulders formation of Homestake (DTL, August 6, page 6) illustrates the scope of the risk, and the possibility that those gold enthusiasts who have not already been discredited may soon lose whatever credibility that they have if that trapdoor opens. Under the circumstances, we are content to let the market tell its own story, and I am grateful to you for maintaining your total objectivity over these many months."

Friend Eliot Janeway writes in his Janeway Letter, "Treasury Secretary Simon has thrown a triple punch at Russia: He forced her to sell her gold; he decided to start selling US gold; and then he persuaded the IMF to start selling its gold. The full force of punches two and three is still being held in reserve." And later Janeway adds, "Expect gold shares to develop even more downside leverage than gold bullion, and especially now that dividend cuts are about to be forced on S.African mines .... Regard $100 an ounce as an important test for the bear market in gold; this lowers my sights from the $125 level I first went public with."

So I'll end my gold discussion this time by repeating that I believe gold is in a bear market, and in bear markets (unfortunately) news tends to go with the trend. In other words, the emerging news tends to be taken bearishly, which is pretty much what we have been seeing over the past year as the forces of the gold bears apply their full strength. Ultimately, gold will have discounted the worst as far as its future is concerned. At that time, I hope to be able to say one word to my subscribers regarding gold. That word will be, "Go!"



STOCKS, THE BIGGIE: US Steel was really the feature of the latest market rally (July to September). Big Steel happens to be a stock that I repeatedly recommended in earlier Letters, prior to the Steel's big run into the 60's. Later I drew attention to the "head-and-shoulders" top which was forming in Steel, and you can study this formation as I have shown it on my daily chart (the LS on chart denotes the left shoulder, the H designates the head and RS refers to the right shoulder). The support came in at 55, and this was the level I told subscribers to watch.

Despite perfect volume indications for a top (i.e., progressively lower volume on LS, H and RS), Steel refused to break down below the 55 level. In July, Steel reconsolidated at the 57 level, then mounted a spectacular run to 71½. Nevertheless, the appearance of a head-and-shoulders pattern generally means that a good deal of distribution has taken place. In September, Steel churned heavily on high volume, then broke down into the mid-60's.

I am now watching Steel carefully because (1) US Steel is the nation's largest steel producer, (2) steel production is a good harbinger of the economy, (3) US Steel has been the strongest Dow stock on the Board. If Steel breaks it trendline and drops below 63, it will appear to be topping. But the critical area for Steel is still 55-57. If Steel can manage to hold above 55 (and hopefully above 60), it will be a hopeful omen for the market as a whole. If Steel can hold above the trendline at 65, it will be a real comfort. Let's watch the Big X, it is probably the most important stock on the Board at this time.

LATE NOTES: Mountain States Telephone is coming out with Aaa-rated bonds which will probably yield 9.55% (to mature in 40 years). The Treasury announced new two-year notes to yield (best guess) around 8.5%. Uncle is taking on all comers for money now, and the money markets are in the process of drying up. Why shouldn't they; each time you buy 'em you read (next day) about bigger bargains!

Stocks can't compete with that kind of action. The debt is swallowing up everything like a whale diving through a school of anchovies. If NYC is known as the "Big Apple," how long will it be before they call the Treasury the "Big Vacuum Cleaner." Everything is retreating now, in the face of the giant cash needs, and the dollar (at least temporarily) is King Kong. The stock market is retreating to safer ground, and on Wall Street safer ground is always lower ground. When the market finally discounts the worst, it will stop, dig in, and take its stand against the bears. Until then, as I've been saying, this is a secondary reaction (and it's turning into a beaut). As this is written the Dow is testing the 800 level again. Watch the 791.69 point for the Dow.

Next mailing: September 26th.